

PERSONAL INCOME TAX BULLETIN 2010-02

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Guidance for Investors in Fraudulent Investment Schemes

The purpose of this bulletin is to provide guidance to investors in fraudulent investment schemes, commonly known as "Ponzi schemes". Section I of the bulletin sets forth the general tax treatment regarding the reporting of fictitious income from a fraudulent investment scheme. Generally, fictitious income increases the basis in the taxpayer's investment. As a result, the taxpayer's loss, if any, upon final disposition of the investment interest will be greater on account of the increase in basis from the fictitious income reported in prior years. This section also describes general rules for calculating the amount of a taxpayer's loss upon final disposition.

Section II sets forth the requirements to timely file a petition for refund with the Board of Appeals of tax erroneously paid due to fictitious income from a fraudulent investment scheme. If a taxpayer chooses not to file a petition for refund, if the period for filing a petition for refund has closed for some or all tax years, or if the Board denies relief, any fictitious income will be treated as set forth in Section I of the bulletin.

Section III provides three comprehensive examples illustrating how to calculate the amount of fictitious income to be removed and how to calculate the amount of any loss upon disposition of an interest in a fraudulent investment scheme.

The taxpayer should be aware that the Internal Revenue Service ("IRS") has published guidance on the application of Internal Revenue Code ("IRC") § 165 losses from fraudulent investment schemes. Since Pennsylvania law does not have a corresponding provision to IRC § 165, the Department does not follow the Federal income tax treatment of losses from fraudulent investment schemes.

Section I. Fraudulent Investment Schemes.

1. General Rule: If a taxpayer reports fictitious income from a fraudulent investment scheme in a prior tax year, the income reported increases the taxpayer's basis in the investment. Any gain or loss will be recognized upon the final disposition of the investment.
 - a. The loss or gain shall be reported as a loss or gain from the sale, exchange or disposition of property on Schedule D of the PA-40 for the tax year for which the final disposition occurred. The final disposition occurs in the year in which some identifiable event closed and completed the transaction and fixes the amount of the loss so there is no possibility of any eventual recovery or recoupment.

- i. The period for recovery will be deemed to be final at the conclusion of all legal action to obtain a recovery on the investment and/or when the taxpayer receives notification that all proceeds have been paid out of existing funds (or any other legal or final acts to dissolve the investment) or when the taxpayer has provided irrevocable notice in writing to the investment scheme (or any person handling the affairs of the investment scheme) that the taxpayer has relinquished all right, title, and interest in any recovery from the fraudulent investment scheme or the year in which the taxpayer is precluded under state or other applicable law from pursuing any claim for recovery from the fraudulent investment scheme or any third party.
- b. **Gain/Loss.** Taxpayers realize a loss upon a disposition of their investment in the fraudulent scheme to the extent that the taxpayer's basis in the investment is greater than the amount recovered from the investment. Taxpayers realize a gain upon a disposition of their investment in a fraudulent investment scheme to the extent that the amount recovered from the investment is greater than the taxpayer's basis in the investment. The amount recovered from the investment is the amount of cash and the fair market value of other property received in bankruptcy or other type of recovery which may include any insurance coverage, contractual guarantees or any amounts payable from the Securities Investor Protection Corporation or any similar recovery. If a Promissory note is distributed to a taxpayer, then the amount recovered equals the face amount of the note.
- c. **Increases/Decreases to Basis.** A taxpayer's basis in the investment in the fraudulent investment scheme is calculated by subtracting basis reductions from basis increases. Basis reductions include the amount of any distributions of cash or other property received over the life of the investment or in the final year of investment (including the face amount of any promissory note); losses used by the taxpayer in any state including Pennsylvania, any decrease in the taxpayer's allocable share of any entity liabilities. Basis increases include the taxpayer initial investment in the form of cash or other property; income from the investment (whether actual or fictitious) that the investor reported and upon which the taxpayer paid Pennsylvania personal income tax; any further investments in the form of cash or other property; any non-deductible, non-capitalizable expenses; tax exempt income; and any increase in taxpayer's allocable share of any entity liabilities.
- d. **Limitations on Losses:** Losses are only recognized on transactions entered into for profit such as investments, business property, and

real estate. Losses are not recognized on the sale of property that was not acquired as an investment or for profit. A taxpayer with actual or constructive notice of fraud at the time he or she contributed cash or property to a fraudulent investment fund may not claim a loss for any portion of the loss attributable to such contribution.

2. Amended Returns: The Department will not accept amended returns to remove fictitious income due to a fraudulent investment scheme from a prior tax year. To request removal of fictitious income, the taxpayer may file a timely petition for refund pursuant to Section II, below.

Section II. Removal of Income Reported for a Previous Tax Year Due to a Fraudulent Investment Scheme.

1. General Rule: A taxpayer may file a petition for refund with the Board of Appeals ("Board") pursuant to Section 2703 of the Tax Reform Code (72 P. S. § 9703) within the period provided by Section 10003.1 of the Tax Reform Code (72 P.S. § 30003.1).
2. Contents of Petition: In addition to the general filing requirements, a petition filed pursuant to this Bulletin shall include:
 - a. The amount of the refund requested;
 - b. A description of the fraudulent investment scheme;
 - c. A description of the petitioner's relationship to the fraudulent investment scheme;
 - d. A description of the amount and class of income and fictitious income for which a refund is sought.
3. Burden of Proof: The petitioner must prove:
 - a. Petitioner was a direct or indirect investor in the fraudulent investment scheme;
 - b. The amount of fictitious income reported to Pennsylvania in a prior tax year;
 - c. The amount of tax paid as a result of subsection (b), above.
4. Documentation: The petitioner may submit the following documentation to assist the Board in its review of the petitioner's request for the removal of fictitious income reported in a prior tax year:

- a. Copies of any federal income tax returns for the tax years in question;
- b. Copies of any IRS forms such as K-1s or 1099s that reflects the amount and character of the fictitious income;
- c. Copies of the original Pennsylvania personal income tax return including schedules filed with the Department;
- d. Copies of any documents that the petitioner received from the fraudulent investment scheme;
- e. Copies of any amended federal income tax returns including schedules for the tax years for which relief is sought;
- f. Copies of any periodic statement received by the petitioner from the fraudulent investment scheme;
- g. Admission of guilt by the lead figure or figures in a fraudulent investment scheme pursuant to a criminal complaint in the jurisdiction in which the transaction occurred.

In addition to the above, the Board may request any documentation that it deems necessary to assist in the review of the petition.

5. **Decision & Order:** The Board will review the petition and issue a decision and order in accordance with Section 2703(c) of the Tax Reform Code (72 P. S. §9703(c)). A denial of relief means that the petitioner's investment in a fraudulent investment scheme shall be treated in accordance with Section I, above.

Section III. Comprehensive Examples.

Scenario #1.

Taxpayer directly invests \$1 million in an investment entity in 2003. Taxpayer receives a Schedule RK-1 from the entity reporting \$150,000 of dividend income each year for seven years. In each tax year, taxpayer reports the dividends as personal income and timely pays all taxes due for PIT purposes. The dividends from the investment entity are taxpayer's only dividend income for tax years 2003-2009. Taxpayer does not receive any distributions of cash or property from the investment at any time throughout his ownership of the investment (except the recovery described later in this example).

In 2010, taxpayer learns that the entity was a fraudulent investment scheme and that the operator of the scheme has been charged criminally with embezzlement or a similar crime. The operator pleads guilty to these criminal charges. Publicly available

documents contain sworn statements by the operator stating that the investment entity was unprofitable in every year of operation except for 2005 (the entity realized \$50,000 in dividend income) and 2007 (the entity again realized \$50,000 in dividend income).

Taxpayer timely files a petition for refund in 2010 for tax years 2007, 2008, and 2009, to remove the fictitious dividend income. Taxpayer has proven all of the elements required under Section II of this bulletin.

Taxpayer is entitled to a PIT refund of paid tax as follows:

Tax Year	Dividend income as reflected on PA Schedules RK-1	Actual income	Amount of refund
2003	\$150,000	0	None—refund petition period is closed for this tax year. As described in Section I, this fictitious income increases any loss upon disposition of the investment interest.
2004	\$150,000	0	None—refund petition period is closed for this tax year. See Section I.
2005	\$150,000	\$50,000	None—refund petition period is closed for this tax year. See Section I.
2006	\$150,000	0	None—refund petition period is closed for this tax year. See Section I.
2007	\$150,000	\$50,000	$\$150,000 - \$50,000 = \$100,000$ $* .0307 = \$3,070.$
2008	\$150,000	0	$\$150,000 * .0307 = \$4,605.$
2009	\$150,000	0	$\$150,000 * .0307 = \$4,605.$

In 2010, taxpayer filed a claim with a bankruptcy court handling the disposition of the assets of the fraudulent investment scheme. The bankruptcy court issues an order in 2011, and the period for appeal from the court’s order expires in 2011. Taxpayer is entitled to receive \$515,000, comprised in part of recovery from the investment scheme’s assets and in part from a recovery pursuant to the Securities Investor Protection Act.

Taxpayer recognizes a \$1,135,000 loss upon disposition of property for tax year 2010, calculated as follows:

A PIT **loss** results to the extent that the **amount recovered < basis.**

- Taxpayer’s “amount recovered” is **\$515,000.**
- Taxpayer’s “basis” in the investment is **1,650,000**, calculated as follows:

- \$1 million initial investment
- + \$150,000 reported in tax year 2003;
- + \$150,000 reported in tax year 2004;
- + \$150,000 reported in tax year 2005;
- + \$150,000 reported in tax year 2006;
- + \$150,000 reported in tax year 2007;
- + \$150,000 reported in tax year 2008;
- + \$150,000 reported in tax year 2009;
- \$100,000 for tax year 2007 fictitious income for which taxpayer filed a petition for refund;
- \$150,000 for tax year 2008 fictitious income for which taxpayer filed a petition for refund;
- \$150,000 for tax year 2009 fictitious income for which taxpayer filed a petition for refund.

= 1,650,000 (Total basis)

Taxpayer’s amount recovered (\$515,000) is less than his basis (\$1,650,000) to the extent of \$1,135,000; therefore, this is the amount of taxpayer’s loss.

Scenario #2.

Assume the same facts as Scenario #1, except assume that in tax year 2008 the fraudulent investment scheme issued a Schedule RK-1 reflecting net gains from disposition of property equal to \$50,000 (in addition to the dividend income described in Scenario #1).

Further, assume that in tax year 2009, the fraudulent investment scheme issued a Schedule RK-1 reflecting net gains from disposition of property equal to \$50,000 (in addition to the dividend income described in Scenario #1). Assume that this gain was offset on taxpayer’s individual return by a net loss from disposition of property (unrelated to the fraudulent investment scheme) equal to \$50,000, resulting in \$0 net gain or loss from disposition of property.

Taxpayer files a petition for refund for tax year 2008. Taxpayer is entitled to a refund of the tax related to the \$50,000 of net gain reported on the individual return, as well as

to a refund of the tax related to the \$150,000 of dividend income. Taxpayer's refund for 2009 is \$6,140, consisting of the \$4,605 of tax paid on the dividend income as illustrated in the table in Scenario #1 (\$150,000 of dividend income * .0307 tax rate equals \$4,605), plus the \$1,535 of tax paid on the net gain (\$50,000 of net gain * .0307 tax rate equal \$1,535).

Taxpayer files a petition for refund for tax year 2009. Taxpayer is entitled to a refund of the tax related to the dividend income. Taxpayer's refund for 2009 is \$4,605, equal to the tax paid on the dividend income as illustrated in the table in Scenario #1 (\$150,000 of dividend income * .0307 tax rate equals \$4,605). Taxpayer, however, is not entitled to a refund of the tax relating to the capital gain income because the taxpayer did not pay tax on this income. Since taxpayer did not receive a refund with respect to this income, taxpayer is not required to reduce his basis in the investment interest by the \$50,000 representing net gain that was reported to taxpayer by the fraudulent investment scheme.

Taxpayer's loss on the disposition of the investment interest upon the recovery of \$515,000 (described in Scenario #1) is calculated as follows:

- **Taxpayer's "amount recovered" is \$515,000.**
- **Taxpayer's "basis" in the investment is 1,700,000**, calculated as follows:

- \$1 million initial investment
- + \$150,000 reported in tax year 2003;
- + \$150,000 reported in tax year 2004;
- + \$150,000 reported in tax year 2005;
- + \$150,000 reported in tax year 2006;
- + \$150,000 reported in tax year 2007;
- + \$200,000 reported in tax year 2008 (consisting of dividend income and net gain reported to taxpayer by the fraudulent investment scheme);
- + \$200,000 reported in tax year 2009 (consisting of dividend income and net gain reported to taxpayer by the fraudulent investment scheme);
- \$100,000 for tax year 2007 fictitious income for which taxpayer filed a petition for refund;
- \$200,000 for tax year 2008 fictitious dividend income and net gain for which taxpayer filed a petition for refund;
- \$150,000 for tax year 2009 fictitious dividend income for which taxpayer filed a petition for refund (recall that no reduction is required for the net gain because taxpayer did not receive a refund with respect to this income).

= 1,700,000 (Total basis)

Taxpayer's amount recovered (\$515,000) is less than his basis (\$1,700,000) to the extent of \$1,185,000; therefore, this is the amount of taxpayer's loss.

Scenario #3.

Assume the same facts as Scenario #1 except assume that in tax year 2009, the fraudulent investment scheme issued a Schedule RK-1 reflecting net gains from disposition of property (unrelated to the fraudulent investment scheme) equal to \$200,000. In 2009, taxpayer also realized a net loss from the disposition of a building in the amount of \$600,000.

On taxpayer's petition for refund, he seeks a refund for any personal income tax paid on account of the net gains class of income (in addition to seeking the refund of tax resulting from the dividend income).

Taxpayer is not entitled to a refund related to this net gain, because taxpayer did not pay tax on the net gain flowing through from the fraudulent investment scheme. Therefore, taxpayer's refund for 2009 is \$4,605, resulting from refund of the tax paid on the dividend income as illustrated in the table in Scenario #1 (\$150,000 of dividend income * .0307 tax rate equals \$4,605).